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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Contact: None
Index No.: 703.05-00; 1031.05-00; 1033.00-00
Control No.: TAM-103428-98

Taxpayer's Name:
Taxpayer's Address:

TIN:
Years Involved:
Date of Conference:

LEGEND:

Taxpayers =

Property 1 =
Apartment Building =
Property 2 =
Property 3 =
Real Estate Venture =

A =
B =
C =
D =
Year 1 =
Date 1 =
Date 2 =
Date 2A =
Date 3 =
Year 3 =
Year 20 =
Date 4 =
Date 5 =
Date 6 =
Year 25 =
x =
Natural Disaster =
Accommodator =
$y =

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ISSUES:

(1) Whether Taxpayers are entitled to deferral of gain from the involuntary conversion of Apartment Building under § 1033 of the Internal Revenue Code.

(2) Whether Taxpayers are entitled to deferral of gain from the disposition of Property 1 in an exchange under § 1031 of the Code, following the involuntary conversion of Apartment Building.

CONCLUSIONS:

(1) The partnership of which Taxpayers are partners that was formed to own and operate Apartment Building and Property 1 is entitled to deferral of gain from the involuntary conversion of Apartment Building under § 1033 of the Code.

(2) The partnership of which Taxpayers are partners that was formed to own and operate Apartment Building and Property 1 is entitled to treat the disposition of Property 1 and acquisition of Property 3 as a like kind exchange under § 1031 of the Code but must recognize gain in an amount not to exceed $y.

FACTS:

A owned commercial property, including Property 1. On Date 1 of Year 1, A pooled his commercial property and some cash with cash advanced by B and C. As part of this transaction, A deeded an undivided 37% interest to B as co-tenant and an undivided 16% interest to C as co-tenant in the commercial property, retaining a 47% interest for himself.

A, B, and C then secured a loan from a bank in their individual names to build Apartment Building on Property 1. Apartment Building was constructed and placed in service as Real Estate Venture on Date 2A. This improvement was insured in the names of A, B, and C.

A Form 1065, U.S. Partnership Return of Income, was filed each year in the name of Real Estate Venture from Year 3 to Year 25. Apartment Building and the underlying real property (Property 1) were listed on the balance sheet of the Form 1065. Interest, taxes and depreciation on Apartment Building and Property 1 were taken as deductions on the Form 1065.

A bank account was opened in the name of Real Estate Venture. Rent from Apartment Building was deposited in this account and all disbursements for Apartment Building and Property 1 were paid from this account. Although invoices for insurance premiums, real estate taxes and mortgage payments were sent to A, B, and C individually, these invoices were paid from Real Estate Venture's bank account.

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A, B, and C entered into a "partnership agreement" with regard to Real Estate Venture on Date 2. Section 2 of the partnership agreement provides that the purpose of the partnership shall be to construct and operate a x-unit apartment house on the real estate shown on Exhibit A (Real Estate Venture) and one other apartment house on other real estate. Exhibit A refers to Apartment Building located on Property 1. Section 3 provides that the partnership shall commence on the date of the agreement and shall continue until dissolved as provided in the agreement or by operation of law. Section 4 provides that the capital contributions of the partnership shall be set forth on Exhibit B. Exhibit B provides that A, B, and C made contributions to the partnership in exchange for a corresponding percentage in the partnership. Exhibit B states that A's contribution includes the land on which the apartment complex was built. Section 4 also provides that the depreciation of the assets of the partnership shall inure in accordance with the percentage interest set forth on Schedule B. Section 5 provides that the net profits and losses shall be divided in accordance with the interests set forth on Schedule B. Section 7 provides that B shall have the obligation of the management, conduct and operation of the partnership business. The consent of all partners is required in the event that any or all of the partnership assets are to be sold, mortgaged or otherwise encumbered or money borrowed on behalf of the partnership. However, in the event that the partners cannot reach a joint decision with respect to any sale or borrowing, then the majority vote as computed by voting the percentage interest of ownership shall prevail. Section 9 permits the partnership to have a bank account at a selected bank and in such other banks as the managing partner shall select. Section 10 provides that upon a voluntary termination of the partnership, the partners shall proceed with reasonable promptness to sell the real and personal property of the partnership and that the partnership shall be dissolved by the sale of all the real and personal assets of the partnership. Section 11 provides that a partner may retire at the end of a fiscal year and that the other partners shall have the right to purchase the retiring partner's interest. A, B, and C signed the agreement as partners.

In Year 20, B transferred half of his interest to his wife, D, pursuant to their divorce settlement. Over the years, A, B, C, and D, by quit claim deeds, transferred their interests in the land to revocable trusts, treated as grantor trusts by A, B, C, and D.[1] The grantor of each trust is also the trustee of the trust.

Despite the partnership agreement, Real Estate Venture bank account, and Real Estate Venture's filing of partnership tax returns, the mortgage loan documents, insurance policies and property tax documents indicate that Taxpayers owned Apartment Building and Property 1 in undivided interests. Further, Taxpayers represent that they entered into the partnership agreement solely for the purposes of constructing and operating Apartment Building and

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[1] For purposes of this ruling, reference to A, B, C, and D includes the individuals and their respective grantor trusts.

that they never intended to transfer ownership of either Property 1 or Apartment Building to the partnership. Taxpayers assert that they have not formed a partnership for federal income tax purposes.

Real Estate Venture employed an on-site manager, a management company and a bookkeeping service. Taxpayers represent that they have never furnished to their tenants any but customary services in connection with an apartment house rental operation.

Apartment Building on Property 1 was destroyed by Natural Disaster on Date 3. A, B, C, and D filed insurance claims and received cash in settlement of their claims. A, B, C, and D subsequently determined that Apartment Building could not be repaired.

A, B, and D used their share of the insurance proceeds to purchase Property 2. Property 2 is a property similar or related in service or use to Apartment Building and was intended to qualify as replacement property under § 1033. The purchase price of Property 2 exceeded the gain realized by A, B, and D (and C) from the conversion of Apartment Building.

A, B, and D thereafter attempted a deferred exchange of their respective interests in Property 1 for Property 3. A, B, and D intended this transaction to qualify as a like-kind exchange under § 1031. Specifically, the transaction was structured as follows:

1. A, B, C, and D located a potential buyer for Property 1.

2. A, B, C, and D each retained Accommodator and each executed an exchange agreement with Accommodator. Under the agreements, A, B, C, and D could not receive any cash or borrow or pledge against the sale proceeds of Property 1 until after the expiration of the statutory period for identifying and acquiring the replacement property. However, the agreement could be terminated and the sales proceeds obtained if the transferor did not identify replacement property prior to the end of the statutory 45-day period for identifying replacement property.

3. A, B, C, and D conveyed their respective interests in Property 1 to Accommodator, who conveyed them to a buyer on Date 4 through a sale escrow account established with an affiliate of Accommodator.

4. All proceeds from the sale of Property 1 were received by Accommodator who set up a separate "exchange account" for each of A, B, C, and D.

5. A, B, and D identified Property 3 as the qualifying replacement property on Date 5 (a date within the statutory 45-day period for identifying replacement property). C did not identify replacement property.

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6. Accommodator acquired Property 3 through a replacement escrow account and transferred undivided interests in that property to A, B, and D on Date 6 (a date within the statutory 180-day period for acquiring replacement property). C did not reinvest in replacement property and received cash in the amount of $y.

All of these steps in this transaction were executed by A, B, and D separately as trustees on behalf of the grantor trusts and not by Real Estate Venture. No other facts are available concerning what C did with his share of the proceeds from the sale of Property 1 or from the insurance proceeds.

LAW AND ANALYSIS:

Partnership or Co-ownership

Section 761 provides that the term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not a corporation, trust or estate.

The determination of whether a partnership exists is to be made considering whether in view of the parties' actions, the parties acting in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. Commissioner v. Culbertson, 337 U.S. 733, 742 (1949).

In McManus v. Commissioner, 583 F.2d 443 (9th Cir. 1978), taxpayers acquired real estate for development and title to the property was placed in their names as individuals. During the tax years the taxpayers held the property, financial transactions were recorded in books that contained capital accounts for the "partners"; bank records indicated the taxpayers were partners; and their attorneys, with the taxpayers' affirmation, referred to the taxpayers as partners. Moreover, partnership returns were filed on behalf of the taxpayers until, upon the advice of legal counsel, the practice was discontinued. The taxpayers argued that they never intended to enter into a partnership and thus were not partners for federal tax purposes. The Tax Court found that the parties had acted in a way that sufficiently evidenced the relationship to be that of partners in a partnership. In affirming the Tax Court, the Court of Appeals for the Ninth Circuit considered the keeping of books on a partnership basis, the maintaining of a "partnership" bank account, and "most importantly" the filing of partnership returns. The Ninth Circuit stated that the holding of the property as tenants in common was at best neutral evidence. The court found that the Tax Court's decision was not erroneous and noted that, in any case, a taxpayer is estopped from later denying the status he claimed on his tax returns.

In Rev. Rul. 75-374, 1975-2 C.B. 261, two parties each own an undivided one-half interest in an apartment project. A management company retained by the co-owners manages the building. Customary tenant services such as heat and water, unattended parking, trash removal, normal repairs, and cleaning of public areas are furnished at no additional charge. Additional services, such as attendant parking, cabanas, and gas and electricity are furnished by the management company for a separate charge. The ruling holds that the furnishing of customary services in connection with the maintenance and repair of an apartment project will not render a co-ownership a partnership. The revenue ruling concludes that since the management company is not an agent of the owners and the owners did not share in the income earned from the additional services, the owners were not furnishing services. Therefore, the owners are to be treated as co-owners and not as partners under § 761.

Taxpayers argue that they never intended to form a partnership with regard to the ownership of Apartment Building and Property 1. Taxpayers' representative, who is also the accountant who filed the Forms 1065 for Real Estate Venture, explained that he reported Real Estate Venture's income in this manner for the convenience of the individuals in reporting taxable income and for the convenience of the Internal Revenue Service in examining returns, and that he and many other tax professionals understood this practice as done for reporting purposes only and not as an assertion of a form of ownership.

In this instance, we conclude that the filing of partnership tax returns, the "partnership agreement" entered into by A, B, and C, and the conduct of the parties indicates an intention to operate Real Estate Venture as a partnership. Further, the inclusion of Apartment Building on the balance sheet of the Form 1065, the reporting of depreciation, real estate tax expense and mortgage interest expense on the partnership return, the payment of these expenses from a bank account held in the name of "Real Estate Venture" and the language used in the partnership agreement indicate an intention to treat Apartment Building and Property 1 as assets of the partnership for federal income tax purposes. Accordingly, we conclude that the arrangement between A, B, C, and D regarding Real Estate Venture was, and continues to be, a partnership for federal income tax purposes. Apartment Building and Property 1 were assets of a partnership for federal income tax purposes.

Taxpayers also argue that Real Estate Venture is not a partnership because, similar to the situation in Rev. Rul. 75-374, A, B, C, and D do not furnish their tenants with any but the customary services in connection with apartment house rental operations. Without making a determination concerning the level of services furnished by A, B, C, and D, we conclude that the filing of partnership returns for more than twenty years, the "partnership agreement," and the conduct of the parties (not relating to services) require a result different from the one reached in Rev. Rul. 75-374.

Section 1033

Section 1033(a) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is involuntarily converted into money, and if the taxpayer during the two

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years following the date on which gain from any part of the conversion is realized purchases other property similar or related in service or use to the property so converted for the purpose of replacing the converted property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other (replacement) property.

Section 703(b) of the Code provides that any election affecting the computation of taxable income derived from a partnership (with certain exceptions not including the election under § 1033) shall be made by the partnership.

Section 1.1033(a)-2(c)(2) of the regulations provides, in part, that all of the details in connection with an involuntary conversion of property at a gain (including those relating to the replacement of the converted property, or a decision not to replace, or the expiration of the period for replacement) shall be reported in the return for the taxable year or years in which any of such gain is realized. It further provides, in part, that a failure to so include such gain in gross income in the regular manner shall be deemed to be an election by the taxpayer to have such gain recognized only to the extent the amount realized on the conversion exceeds the cost of the replacement property, even though the details in connection with the conversion are not reported in such return.

In the case of a partnership the nonrecognition of gain election under § 1033 and the replacement of property converted can only be made by the partnership and not the partners individually. Rev. Rul. 66-191, 1966-2 C.B. 300; McManus v. Commissioner, 583 F.2d 443 (9th Cir. 1978); Demirjian v. Commissioner, 457 F.2d 1 (3rd Cir. 1972).

In accordance with our conclusion that the arrangement between A, B, C, and D is a partnership for federal income tax purposes (hereinafter, ABCD Partnership), it follows that the election under § 1033 and the replacement of the converted property must be made by ABCD Partnership. A, B, C, and D joined together as a partnership in Real Estate Venture, a rental real estate business. Although C redeemed his interest in ABCD Partnership, the partnership continued its rental real estate business when it received the insurance proceeds and purchased the replacement property, Property 2. Thus, for federal income tax purposes, ABD Partnership is a continuation of ABCD Partnership and the replacement of the converted property was made by the same partnership, now ABD Partnership. This same partnership also did not include gain on its federal income tax return from the conversion of Apartment Building in the tax year that gain was realized from the conversion. Therefore, ABCD Partnership made a § 1033 election and made a timely replacement of the converted property (Apartment Building) by acquiring Property 2, which is property similar or related in service or use to the converted property. Accordingly, ABCD Partnership is entitled to deferral of gain from the involuntary conversion of Apartment Building under § 1033 of the Code.

Section 1031

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Section 1031(a)(1) of the Code provides that no gain or loss shall be recognized on the exchange of property for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

Section 1031(a)(3) of the Code provides that for purposes of this subsection, any property received by the taxpayer shall be treated as property which is not of like kind if--(A) such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (B) such property is received after the earlier of (i) the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or (ii) the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs ("exchange period").

Section 1031(b) of the Code provides that if an exchange would be within the provisions of § 1031(a) if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Property 1 is of like kind to Property 3. Moreover, the transaction ostensibly satisfies these timing requirements for identification and receipt of replacement property. ABCD Partnership identified Property 3 as replacement property within 45 days after the transfer of Property 1. Furthermore, ABD Partnership, as a continuation of ABCD Partnership, received the replacement property pertaining to the exchange within the statutory replacement period. However, compliance with these timing rules will not assure ABCD Partnership of avoiding actual or constructive receipt of cash or other non-like-kind property unless there is also compliance with certain additional requirements. These rules are precautionary measures (or "safe harbors") set forth in the regulations to help taxpayers insure that the transaction is indeed an exchange of like-kind properties, as opposed to a mere sale/repurchase. These safe harbors were promulgated to provide specific measures which taxpayers could follow in order to avoid actual or constructive receipt of money or other property (not of like kind) between the time of relinquishment and the time of replacement.

Section 1.1031(k)-1(f)(1) of the regulations provides in part that a transfer of relinquished property in a deferred exchange is not within the provisions of § 1.1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of either § 1031(b) or (c). In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property.

In addition, actual or constructive receipt of money or other property by an agent of the taxpayer is actual or constructive receipt by the taxpayer. Section 1.1031(k)-1(f)(2) explains that except as provided in paragraph (g) of this section (relating to safe harbors), for purposes of § 1031 and this section, the determination of whether (or the extent to which) the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property, is made under the general rules concerning actual or constructive receipt and without regard to the taxpayer's method of accounting. The taxpayer is in actual receipt of money or property at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property. The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given. Although the taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions, the taxpayer is in constructive receipt of the money or property at the time the limitations or restrictions lapse, expire, or are waived. In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section) is actual or constructive receipt by the taxpayer.

Section 1.1031(k)-1(g)(4) provides a safe harbor for qualified intermediaries. If the taxpayer utilizes a qualified intermediary, the determination of whether the taxpayer is in constructive receipt is made as if the qualified intermediary is not an agent of the taxpayer. Section 1.1031(k)-1(g)(4)(i) of the regulations provides that in the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is not considered the agent of the taxpayer for purposes of § 1031(a). Paragraph (g)(4)(ii) states that paragraph (g)(4)(i) applies only if the agreement between the taxpayer and the qualified intermediary expressly limits the rights of the taxpayer to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in paragraph (g)(6) of this section.

Section 1.1031(k)-1(g)(6)(i) of the regulations provides that an agreement limits a taxpayer's rights as provided in this paragraph (g)(6) only if the agreement provides that the taxpayer has no rights, except as provided in paragraphs (g)(6)(ii) and (g)(6)(iii) of this section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period. Section 1.1031(k)-1(g)(6)(ii) states that the agreement may provide that if the taxpayer has not identified replacement property before the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period. Section 1.1031(k)-1(g)(6)(iii)(A) states that the agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property after the receipt by the taxpayer of all the replacement property to which the taxpayer is entitled under the exchange agreement.

Section 1.1031(k)-1(g)(4)(iii) of the regulations provides that a qualified intermediary is a person who--(A) is not a taxpayer or a disqualified person, and (B) enters into a written exchange agreement with the taxpayer (the "exchange agreement") and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.

Section 1.1031(k)-1(g)(3) provides a safe harbor for qualified escrow accounts and qualified trusts. Section 1.1031(k)-1(g)(3)(i) provides that in the case of a deferred exchange, the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property will be made without regard to the fact that the obligation of the taxpayer's transferee to transfer the replacement property to the taxpayer is or may be secured by cash or a cash equivalent if the cash or cash equivalent is held in a qualified escrow account or in a qualified trust. A qualified escrow account is defined as an escrow account wherein (A) the escrow holder is not the taxpayer or a disqualified person (as defined in § 1.1031(k)-1(k)), and (B) the escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account as provided in § 1.1031(k)-1(g)(6). Section 1.1031(k)-1(g)(3)(v) provides that a taxpayer may receive money or other property directly from a party to the exchange, but not from a qualified escrow account or a qualified trust without affecting the application of paragraph (g)(3)(i) of this section.

In the present case, although there is no written exchange agreement executed on behalf on ABCD Partnership, the exchange agreements with Accommodator entered into by the individual partners A, B, C, and D have the effect of a written exchange agreement between ABCD Partnership and Accommodator. Accommodator acquired Property 1, the relinquished property, from ABCD Partnership, transferred it to the buyer, acquired Property 3, the replacement property, and transferred it to ABD Partnership, as a continuation of ABCD Partnership. However, ABCD Partnership, through its partner C, actually or constructively received $y cash proceeds from the sale of Property 1 prior to its receipt of the replacement property. This receipt of $y is a direct disbursement by Accommodator to C of ABCD Partnership's proceeds from the sale of Property 1. Thus, the exchange agreement between Accommodator and ABCD Partnership does not satisfy the requirements of § 1.1031(k)-1(g)(4)(ii) because the agreement did not in fact limit the taxpayer's (ABCD Partnership) rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in § 1.1031(k)-1(g)(6).

However, although ABCD Partnership's exchange agreement with Accommodator does not satisfy the qualified intermediary safe harbor, there is the question whether any of the separate exchange accounts attributable to A, B, C, and D satisfy the requirements for qualification as a qualified escrow account under § 1.1031(k)-1(g)(3). Under these facts, the exchange accounts are properly considered accounts of ABCD Partnership. By their terms, the

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exchange accounts attributable to A, B, C, and D each satisfy the qualified escrow account safe harbor. However, notwithstanding that the exchange accounts considered separately satisfy the qualified escrow account safe harbor, ABCD Partnership actually or constructively received money before the end of the exchange period in violation of § 1.1031(k)-1(g)(6)(i) because C did not identify replacement property and received his share of the partnership's proceeds from the sale of Property 1 ($y) in cash. Actual or constructive receipt of money occurred only as to the exchange account attributable to C and not as to the money held in the other exchange accounts.

Accordingly, the exchange of Property 1 for Property 3 qualifies as a deferred like kind exchange under §§ 1031(a)(1) and (3) of the Code; however, pursuant to § 1031(b), ABCD Partnership must recognize gain in an amount not to exceed $y.

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A copy of this technical advice memorandum should be given to the taxpayers. Section 6110(j)(3) of the Code provides that a technical advice memorandum may not be used or cited as precedent.

-END-